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How to alleviate poverty in Ukraine: tips from an experienced Slovak politician

Miroslav Beblavy, State Secretary of the Slovak Ministry of Labor, Social Affairs and Family, thinks that macroeconomic stability and growth alone are not enough to alleviate poverty. A country needs to use additional influences such as tax reform, incentives to work in the legal economy, more affordable loans for small businesses, and changes to labor regulations. These ideas and more were presented in a policy brief prepared by Mr. Beblavy under a joint ICPS-INEKO project

How to go about creating more work

For Central Europe, and probably for Ukraine, too, it makes sense to focus on four key objectives in anti-poverty policy: increasing employment, reducing absolute poverty and preventing long-term poverty, and improving social mobility. Our discussion of instruments will be divided essentially into two parts. The first one is concerned with stimulating employment in the formal economy. The second one focuses on other specific policies aimed at social inclusion that seek to reduce absolute poverty and its reproduction, in addition to a robust employment policy.

Stimulating employment in the formal economy is the lynchpin of any anti-poverty strategy in middle-income countries such as Ukraine. The strategy must focus both on the migration of jobs from the informal economy to the formal one, as well as creation of legitimate jobs. Any repressive element—the police, the tax authorities, and so on—must play only a complementary role. The key, then, is to make job creation in the formal economy more attractive. This can be usually achieved by a mixture of measures:

Changing the tax system. These steps usually include cutting tax rates, broadening the tax base, improving tax administration for better collection, shifting taxes from labor to consumption, and introducing systems that make avoidance more difficult. Successful strategies usually entail eliminating most, if not all, targeted tax breaks and subsidies in favor of a relatively low rate across the board, focusing on VAT and excise taxes as a key source of revenue, reforming the expenditure side of the Budget to allow a decrease in revenues and relatively low rates of personal income tax and social security contributions. Slovakia is a good example of this strategy: it unified its VAT at 19% as of 1 January 2004, created a unified flat personal income tax of 19%, eliminated double taxation (such as dividend tax) and cut social security contributions by more than 3pp.

Attracting individuals to the formal economy. As long as there is a limited relationship between payments made by the individual (taxes and social security contributions) and what the person gets back from the state, there is no incentive to participate in the formal economy as people get nothing in return. Reforms in CE countries have strongly linked social payments from the state to contributions from the individual. In Hungary, Poland and Slovakia, “second pillars” have been set up in the pension system, whereby a significant part of each person’s contributions is diverted into individual pension accounts. Even in the remaining public pay-as-you-go pension systems, there is a tendency to strengthen the link between contributions and pensions, sickness benefits and other payments.

Easing individual and business financing. One of the main barriers to business development and economic growth is insufficient access to financing, be it loans or infusions of capital. As Hernando De Soto has shown, these problems are largely related to problems with collateral, caused, in its turn, by faulty legal systems and unclear property rights. Even in poorer countries, most people have assets, sometimes very significant ones. But either their ownership is not formalized or there are problems with pledging such assets effectively as a collateral for loans.

The other common problem is a generally underdeveloped banking sector, extensive state involvement in banking activities instead of simple regulation, and the “protection” of borrowers from creditors that makes commercial banks reluctant to lend. Radical restructuring and privatization of banks has been a key pillar of all successful economic policies in Central Europe. Countries such as Hungary that have done it sooner have been more successful—and did it more cheaply than laggards such as Poland, the Czech Republic or

To be continued!

The Institute for Economic and Social Reforms (INEKO), a Bratislava think-tank, has joined forces with ICPS in a project to improve the level of debate on Ukraine’s economic policy. Top Central European economists, sociologists and politicians have developed five policy briefs on reforming the business environment, taxation, healthcare, and the pension system and on alleviating poverty in their home countries, with recommendations for Ukraine. The authors of these policy briefs come from Slovakia, Poland, Hungary and the Czech Republic. The author of the brief on reforming social security and alleviating poverty was Miroslav Beblavy, State Secretary of the Slovak Ministry of Labor, Social Affairs and Family. Others in the group of foreign experts include Lajos Bokros, Hungary’s ex-Finance Minister, Jan Mladek, a member of the Czech legislature, and specialists from non-government think tanks. For more on the project, see *www.icps.kiev.ua/eng/project.html?pid=67*.

Slovakia. Slovakia, on the other hand, was a world leader in setting up a working system for using movable property (trucks, cars, inventory, and so on) as collateral. Using mortgages to finance business start-ups has been ever more common in recent years.

The clear message is that creating such systems allows many more people to start or develop businesses than specialized state lending or grant programs, it is much cheaper, and these small businesses tend to become principal drivers of employment in the formal economy. Such systems also create a huge incentive for businesses in the informal economy to switch out because there are rewards for owners, such as access to bank loans.

Fixing the regulatory environment, especially for labor. Paradoxically, poorer countries with weaker states tend to have much more complicated and rigid regulations, especially in the labor market. Of course, this is both difficult to enforce and drives employers into the shadow economy. Labor legislation must actually be applied in the country and it should not prevent employers from hiring individuals by, for instance, making it very expensive to lay them off them when necessary. The experience of Central Europe shows that staff cutbacks in large, formerly state-owned enterprises cannot be stopped or prevented, only slowed down. But any delay is either very costly for the government if it subsidizes enterprises to retain workers or can bankrupt the entire enterprise if the government forces it to keep all its workers. In the end, money would be much better spent on retraining, infrastructure or social assistance. In 2003, Slovakia reformed its Labor Code to increase flexibility in working time and in hiring and firing, and to limit the power of trade unions.

How to go about providing greater social inclusion

In addition to a robust employment policy, other policies of social inclusion help reduce absolute poverty and prevent its reproduction. Since such policies need to be appropriate to local circumstances, the principles on which they should be based are more important than the specific form of these policies.

In-kind and conditional transfers. This is a key issue in Ukraine, especially blanket privileges. Central European countries never had an extensive privilege system to begin with and they have progressively eliminated whatever privileges remained while making sure that the government is paying for the ones that remain. Non-monetary privileges have a number of serious flaws: they tend to be costly either for the government or for the provider, they are usually badly targeted and they are often overly generous. At the same time, they tend to trap individuals, who often cannot change their residence, job or other conditions without losing part or all of the benefit.

Some Central European governments, such as Poland and Slovakia, have emphasized in-kind and conditional financial transfers as a complementary instrument for the poor, in addition to basic welfare benefits. Providing shelter or food for the long-term unemployed, subsidizing school lunches, textbooks and other necessities for poor children, housing subsidies conditional on payment of rent and utility prices, or child benefits conditional on school attendance are all part of their social welfare systems. In-kind and conditional financial transfers can be efficient if there is a high probability that unconditional cash transfers would not be spent in a way that reduced future poverty (such as on education or housing costs) and if they complement a basic cash-based welfare system.

Incentives to work. Of paramount importance in the EU as a whole and in Central Europe in particular is designing tax and benefits systems to create incentive to work. Slovakia and Germany started ambitious reforms in this area in 2003 and 2004. These reforms, such as tightening welfare benefits, conditioning welfare benefits on public works, child tax credits, and cuts in social security contributions, seek to make work pay, even work with relatively low pay. In Ukraine, the low level of unemployment benefits means this approach is likely to be less relevant than others mentioned here.

One aspect where no Central European country has been very successful and which may be relevant for Ukraine is the high number of citizens who have lost in the transition: people over 45 with very often quite low levels of education. The ability of these individuals to adjust to the new economy, especially if they lose their jobs, is limited. Their reintegration into the labor market has not been very successful and they either remain among the unemployed (Slovakia and Poland) or have been sent into disability or early retirement (Czech Republic and Hungary).

Targeting social programs. Middle-income countries such as Ukraine cannot sustain the same level of taxation as EU countries and grow strongly enough to reduce poverty at the same time. So it is crucial to avoid the universal welfare states common to many Western European countries and to target social programs instead. There is a widespread misconception that, since almost everyone is poor in countries such as Ukraine, the state needs to subsidize everybody. This ignores the fact that, in the end, subsidies are financed out of taxes paid by these same poor citizens, minus all the costs and inefficiencies of the government.

Successful non-European countries such as Chile or Korea can be a better role model in this respect. Housing, health-care and education programs need to be carefully targeted to guarantee minimum care and access that is in line with what the country can afford. A very good targeting method is to focus on children from lower-income households. Integrated, effective and efficient programs from childbirth to adulthood that ensure reasonably equal access to health care, nutrition and education for all children have been shown to be among the best investments a public sector can make. ■

For journalists

Under the ICPS-INEKO project, Mr. Miroslav Beblavy is ready to comment to the press on Slovak economic reform know-how, on general economic issues pertaining to Slovakia and other Central European countries that joined the EU this year, and to share some thoughts on reforms in Ukraine. You can contact Mr. Beblavy directly at eblavy@employment.gov.sk.

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